Chapter III
Effectiveness of Internal Audit

3.1 Introduction

Internal Audit is one of the main compliance verification mechanisms in the Service Tax department in the era of self-assessment and is undertaken under Rule 5A of Service Tax Rules, 1994. The Internal Audit function involves selection of assessee units on the basis of risk parameters and scrutiny of records of the assessee in a uniform, efficient and comprehensive manner in accordance with the audit standards. For this purpose, the Central Board of Excise and Customs has laid down detailed guidelines in the form of the Service Tax Audit Manual (STAM), 2011 for audit of Service Tax, which prescribe detailed processes for conduct of audit.

3.2 Organisational Set-up

The Service Tax department was restructured in October 2014. Before restructuring, Internal Audit was conducted by an Audit Cell in each Commissionerate, manned by an Assistant/Deputy Commissioner and auditors and headed by an Additional/Joint Commissioner.

After the restructuring, separate Audit Commissionerates were created under the supervision of Directorate General of Audit (DG Audit). Each Audit Commissionerate is assigned jurisdiction over assessees associated with two or three executive Commissionerates.

In the restructured set-up, Audit Commissionerate comprises of a headquarters similar to an Executive Commissionerate and subordinate offices called Circles similar to Divisions. Each Circle is headed by a Deputy/Assistant Commissioner and comprises of Audit Groups equivalent to the Range offices which have Superintendents and Inspectors.

The Directorate General of Audit, Customs and Central Excise, New Delhi (headed by Director General) with its seven zonal units at Ahmedabad, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata and Mumbai, each headed by an Additional Director General, is required to ensure the efficient and effective implementation of the audit system (based on EA 2000 Methodology) and also to evolve and improve audit techniques and procedures through periodic review.

3.3 Audit Objectives

The objective of this audit was to verify the extent of compliance of the Internal Audit Commissionerates with the laid down:-

- Rules/manual/norms/ guidelines and

- Mechanism for the follow-up of audit findings and rectificatory action thereof.

3.4 Audit Criteria

The sources of audit criteria include the provisions/ guidelines in the following Act, Manuals and Circulars of the department:-

a) Rule 5A of Service Tax Rules, 1994

b) Service Tax Audit Manual, 2011

c) Manual for Quality Assurance Review, 2007

d) Notifications, Circulars, Instructions, Guidelines etc issued by the CBEC from time to time

3.5 Scope, Coverage and Audit Methodology

There are 117 executive Commissionerates and 39 offices of exclusive Service Tax and combined Central Excise and Service Tax Audit Commissionerates all over India. 15 Audit Commissionerates out of 39 were selected.

We examined the assessee master files, internal audit files, audit planning register and follow-up register etc. for the period 2012-13 to 2014-15 available with selected Audit Commissionerates and Executive Commissionerates.

3.6 Non-Production of Records

During audit, we requisitioned 750 Assessee Master Files and 1,125 Internal Audit Files against which we received 396 Assessee Master Files and 886 Internal Audit Files. Further we did not receive full records relating to audit planning register, audit follow up register etc. ***In the absence of these records, we are not in a position to comment on the extent of compliance by the Internal Audit Commissionerates with the laid down procedures***.

3.7 Audit Findings

We found instances of non/incomplete maintenance of Assessee Master Files, Audit Planning Register, Audit Follow up Register etc. Further, during scrutiny of sample Internal Audit Files, we noticed lack of documentation of Desk Review, Audit Plan and Verification Report. The observations are discussed in succeeding paragraphs.

3.8   Planning, Desk Review and Conduct of Field Audit

3.8.1   *Assessee Master File*

As per para 6.1.1 of Chapter 6 of Service Tax Audit Manual (STAM), 2011–risk assessment based audit requires a strong database for profiling each taxpayer so that risk factors relevant to a taxpayer may be identified in a scientific manner and audit is planned and executed accordingly.

Further, as per para 6.1.2 of chapter-6 of STAM, 2011, an Assessee Master File (AMF) is required to be maintained in the Audit Cell for each taxpayer registered with the department. The Audit Cell should collect all relevant information and documents about the taxpayer from various sources (including taxpayer himself), arrange it methodically and regularly update it. The AMF should contain all relevant information about a taxpayer in three parts. (i) Taxpayer's profile, (ii) business particulars of the taxpayer and (iii) documents such as application for registration, registration certificate, balance sheets, annual reports, previous Audit Report, LAR etc., pertaining to the taxpayer. The AMF should be maintained as per the format prescribed in Annexure-III to the STAM, 2011. Taxpayer's profiles are also required to be maintained in electronic form.

Of the 15 selected Commissionerates, two Commissionerates[25] did not provide the number of master files created and four Audit Commissionerates[26] did not inform the total number of assessees. In the remaining nine Commissionerates, we observed that against a total number of 5,56,048 registered assessees[27], AMFs were created in respect of only 3,239 assessees (0.58 per cent) for the period 2012-13 to 2014-15.   In Mumbai ST Audit III Commissionerate, no AMF was created. In Delhi ST Audit I Commissionerate, the percentage of the assessees for whom AMF was created was only a miniscule 0.05 per cent (88 AMFs against 1.77 lakh assessees).

In scrutiny of sample files, we observed that

- In 91 per cent of the cases verified (359 out of 396 AMFs made available), AMFs were not found complete/updated as prescribed in Annexure-III of the STAM, 2011.

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[25]   Chennai Audit I and Cochin Audit

[26]   Hyderabad Audit, Lucknow Audit, Patna Audit and Chandigarh Audit

[27]   Ahmedabad Audit II, Jaipur Audit, Bangalore ST Audit, Delhi ST Audit I, Bhopal Audit I, Bhopal Audit II, Bhubaneswar Audit, Mumbai ST Audit III and Kolkata ST Audit.

- In five Commissionerates[28], AMFs were updated after the selection of units for audit.

- 10 Commissionerates[29] did not maintain AMF in electronic format as prescribed in the manual.

We could not examine this aspect in Chennai Audit I, Delhi ST Audit I and Mumbai ST Audit III Commissionerates as no AMF was produced.

Thus the database of the assessees required for risk assessment is not being maintained.

When we pointed this out (October 2015 to April 2016), the Ministry forwarded Commissionerate wise replies, the gist of which is detailed below:

The general response of many commissionerates is that maintaining AMFs for all assessees is not practical given the huge number of assessees and action is being taken to create AMFs for all assessees.

In case of Bhubaneswar I , it was replied that AMFs are created for audited units only and that after formation of Audit Commissionerate and since the audit year 2015-16, the risk factor is calculated centrally by the DG, Audit and made available to all Audit Commissionerates which are relied upon for selection of units for auditing.

Delhi ST-I contested the audit observation stating that it is not practically feasible to create 1.77 lakh AMFs before embarking on audit.   They further stated that as per Board Circular No. 995/2/2015-CX dated 27 February 2015, the list of units to be audited is being centrally prepared by DG Audit based on various parameters and local Commissionerate can tweak the said list by a maximum of 5 per cent and hence, effectively the role of AMF in risk profiling for units to be selected is negligible. They also stated that they are taking up this matter with DG Audit to revise the Audit Manual.

The Ministry simply forwarded responses of Bhubaneswar I and Delhi ST I commissionerates regarding use of risk profiling done by DG Audit, instead of AMFs created by individual commissionerates and replies of other Commissionerates that the AMFs are being created, without giving the Ministry's view on the same.

In view of practical constraints expressed by almost all the commissionerates in maintaining AMFs for all the assessees and response of Bhubaneswar I and Delhi ST I Commissionerates regarding role of DG Audit in calculating risk scores of assessees centrally, the Ministry needs to evolve

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[28]   Ahmedabad Audit II, Jaipur Audit, Bhopal Audit I, Hyderabad Audit and Bangalore ST Audit

[29]   Bangalore ST Audit, Ahmedabad Audit II, Jaipur Audit, Chennai Audit I, Bhopal Audit I, Bhopal Audit II, Hyderabad Audit, Bhubaneswar Audit, Lucknow Audit and Patna Audit

a practical way of risk profiling of assessees by commissionerates which will capture the localised risk and can be used in combination with centralised risk scoring done by DG Audit.

3.8.2   Inadequacy in Risk-Assessment for Selection of Units for Audit

As per para 5.1.2 of the Service Tax Audit Manual (STAM), 2011, the categorization of the audit is to be done on the basis of annual revenue for the preceding financial year. The annual revenue includes cash as well as CENVAT.

We noticed the following inadequacies in selection of units for audit with reference to provisions of STAM, 2011.

- In Mumbai ST Audit III Commissionerate, the selection of mandatory units for the year 2012-13 to 2014-15 was done on the basis of revenue figures available in the Personal Ledger Account (PLA). However, the PLA depicts only cash revenue. Hence, mandatory units were determined only on the basis of cash revenue without the CENVAT element. As such, the selection of units was not as per the norms of the STAM, 2011.

When we pointed this out (November 2015), the Ministry accepted the facts and stated (December 2016) that new norms for selecting the units for internal audit are applicable from 1 July 2015 and the same are being followed now.

- In Bengaluru ST Audit Commissionerate, there was a decline in revenue (99 *per cent*) for the year 2013-14 in respect of 12 assessees and their category had changed from 'A' (mandatory) to C & D (non-mandatory) and none of these units were audited during 2014-15. Since, there was a steep decline in the revenue, the related assessees involving high risk potential should have been selected for audit. Failure of the Commissionerate to do so indicated the inadequacy of risk assessment.

When we pointed this out (December 2015), the Ministry accepted the facts and stated (December 2016) that out of the 12 units, nine units have already been audited and two units are proposed to be audited in the FY17 and one unit had surrendered its registration. The Ministry further added that in three cases, the internal audit had detected audit objections amounting to ₹ 4.81 crore and recovered ₹ one crore.

3.8.3   Inadequate Desk Review/Audit Plan/Verification

a) Prior to actual conduct of audit, the auditors are required to write an intimation letter to the assessee for conduct of audit and to gather as

much information as per the list of documents prescribed[30] for carrying out Desk Review and analyse the information. A list of documents required for carrying out Desk Review is also included in the said Annexure. The objective of desk review is to devise a focused audit plan.

b) After the Desk review, an Audit Plan is prepared to give a reasonable view regarding potential risk areas, abnormal trends and unusual developments, which need detailed verification. Audit Plan should be a clear plan of action in a standard Format[31].

c) The audit party conducts the verification by checking the points mentioned in the Audit Plan. Entry in the Working Papers must be made for each item of the audit plan[32].

To assess the compliance of these three procedures, Audit conducted a test check of 886 assessee audit files in 15 Audit Commissionerates of Service Tax and found inadequate documentation in 185 internal audit files (21 per cent) in nine Commissionerates. Summary of the observations is given below:

• Desk review was either not found attached or inadequately prepared in 55 internal audit files in six Commissionerates[33].

• Audit Plan was not found attached or not prepared as per the prescribed format in 70 Internal Audit Files in three Commissionerates[34].

• Verification report was not found attached as mandated in 134 internal audit files in nine Commissionerates[35].

Some important observations are as under:

• In Cochin Audit Commissionerate and Executive Commissionerates of Trivandrum, Cochin & Calicut, in 20 out of 55 Audit case files, no working papers were prepared. In these cases, the Audit Parties merely prepared a note titled 'Desk Review' indicating the dates of audit and the general areas proposed to be examined during the audit and some basic data like balance sheet, profit & loss account and ER-I returns etc. without

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[30] Annexure IV of the STAM, 2011

[31] Format of Audit Plan as per Annexure VIII of the STAM, 2011 is Subject, Specific Issue, Source Document, Back-up Document, Coverage Period and Selection Criteria.

[32] Format of Verification Report as per Annexure VIII of the STAM, 2011 is Date of verification, Name of the auditor verifying the issue, issue in brief, Ref. No. of Audit Plan, Documents verified, Brief account of the process and extent of verification, Auditor's observation and conclusion in brief, Quantification of revenue, if any and Documents relied upon.

[33] Cochin Audit, Chandigarh Audit, Lucknow Audit, Jaipur Audit, Ahmedabad Audit II and Chennai Audit I

[34] Cochin Audit, Chandigarh Audit and Patna Audit

[35] Cochin Audit, Chandigarh Audit, Kolkata ST Audit, Lucknow Audit, Patna Audit, Ahmedabad Audit II, Chennai Audit I, Mumbai ST Audit III and Jaipur Audit

any analysis of this records. As working papers were not prepared, there was no evidence that there was proper examination of the various financial statements, calculation of various financial ratios and conduct of trend analysis. This indicated that no proper desk review was conducted in these cases affecting the preparation of good quality Audit Plans.

- In Patna Audit Commissionerate, in 55 cases out of 76 cases test checked, Audit plans were not prepared in accordance with provisions of the Service Tax Audit Manual and verification report along with working papers were not found attached in 31 cases.

- In Lucknow Audit Commissionerate out of 57 cases test checked, Desk Review was not prepared in 12 cases and verification reports along with working papers were not prepared in 36 cases.

When we pointed this out (October 2015 to January 2016), the Ministry accepted the audit objection in all the cases and stated (December 2016) that necessary rectification measures were taken/would be taken in due course.

3.8.4   *Inadequate Scrutiny of Internal Audit Files*

As per para 8.4.2 of STAM, 2011, it is the duty of the Audit Cell to examine the draft audit report.

We examined the details available in Internal Audit Files and found lapses in nine Internal Audit Files relating to non/ short payment of Service Tax, non-recovery of mandatory penalty, irregular availing/ utilization of CENVAT credit etc., in three Audit Commissionerates[36] amounting to ₹ 3.24 crore.

The Ministry in its reply (December 2016) accepted the audit objection in two cases[37] and reply of the Ministry is awaited in six cases[38]. The detail of one case is discussed below:

In respect of M/s Essar Offshore Subsea Ltd. in Mumbai ST Audit III Commissionerate, it was noticed that the department had settled three audit paras without recovering the mandatory penalty amounting to ₹ 8.28 lakh. The Ministry replied (December 2016) that the terms "fraud, collusion, willful mis-statement, suppression of facts, contravention of any of the provisions of Chapter or of the rules made thereunder" as used under sub section (4) to Section (73), were not invokable, for imposition of penalty and as the assessee had paid both Service Tax and applicable interest, the taxpayer got

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[36]   Hyderabad Audit, Chennai Audit I and Mumbai ST Audit III

[37]   M/s. Indu Projects Ltd & Ms. Keimed Pvt. Ltd. in Hyderabad Audit Commissionerate

[38]   M/s. Pane NSK Steering System (P) Ltd., M/s. BSNL, M/s. Celebrity Fashions Ltd., M/s. EMI Infrastructure Pvt. Ltd., M/s. MN Ravi Prasad, M/s. Mahindra Integrated Township Ltd. in Chennai Audit I Commissionerate

the benefit of Section 73 (3) of Chapter V of the Finance Act, 1994, which was ratified by the Monitoring Committee Meeting.

The reply of the Ministry is not acceptable as payment of penalty up to 25 per cent of objected money value under Section 73(4A) of the Finance Act, 1994 was mandatory.

Poor desk review and audit planning adversely affected the quality of internal audit. Further, due to non-availability of verification report and working papers, proper accountability of Internal Audit Party (IAP) cannot be ensured.

3.9 Monitoring of Internal Audit Process

3.9.1 *Maintenance of Audit Planning Register (APR)*

As per para 8.5.1 of STAM 2011, the Audit Planning Register is to be maintained in the prescribed format[39]. It will facilitate in ensuring: (i) all units allotted to an Audit Group have been audited; and (ii) wherever audit has been completed, the Audit Reports are issued in time and it will also ensure that if audit of any unit could not be taken up, the same can be included in the schedule for the subsequent period.

We observed in 14 Commissionerates[40], the audit planning register was incomplete/not maintained in the format prescribed in the STAM, 2011 or not produced to the audit.

When we pointed this out (October 2015 to April 2016), the Ministry accepted the facts and stated (December 2016) that now the register is being maintained properly as per new audit manual.

3.9.2 *Maintenance of Audit Follow-up Register*

As per para 8.5.6 of the STAM, 2011 the details of draft Audit Reports discussed by MCM, final decision on the reports is taken in the meeting and the further follow-up action should be entered in the 'Audit Follow-up Register (AFR)'[41] (in the format prescribed in the STAM, 2011), as soon as the Audit Report is approved. The abstract for each month should be put up by

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[39] Format of Audit Planning Register is Sl. No., Name of Unit, IAP No., Propose Month of Audit, Actual Date of Audit, Submission of DAR to Audit Cell, Audit Report No, Date of Issue etc.

[40] Delhi ST Audit I, Chandigarh Audit, Bhopal Audit I, Kolkata ST Audit, Bhopal Audit II (Raipur), Hyderabad Audit, Ahmedabad Audit II, Jaipur Audit, Mumbai ST Audit III, Lucknow Audit, Patna Audit, Chennai Audit I, Cochin Audit {Trivandrum, Calicut, Cochin executive Commissionerates} and Bangalore ST Audit.

[41] Format of Audit Follow up Register is AR No., Name of Assessee, Range and Division, Reg. No. of Assessee, Period of Audit, Date Audit, IAP No., Para No., whether accepted by MCM, duty involved, Spot Recovery, Recovery other than spot recovery before issuance of SCNs, Division file No. SCN No. & Date, Amount in SCN, Reason of closure of para & date of closure of para.

Audit Cell to Additional/Joint Commissioner (Audit) by 10th of the following month.

We observed in Delhi ST Audit I Commissionerate (2014-15) and Ahmedabad Audit-II Commissionerate (2012-13 to 2014-15) that AFR was not maintained. In six Audit Commissionerates[42] and one Executive Commissionerate (Bengaluru), AFR was not properly maintained/ updated. Further, in three audit Commissionerates (Chandigarh, Kolkata ST and Patna), monthly abstracts of AFR were not prepared.

When we pointed this out (October 2015 to April 2016), the Ministry accepted the facts and stated (December 2016) that now the register is being maintained properly as per new audit manual.

3.9.3   *Submission of Draft Audit Report (DAR)*

As per Para 8.1.4 of the Service Tax Audit Manual, 2011, the draft audit report should be submitted by the internal audit party to Audit Circle within the shortest time span possible i.e. within 20-25 days of the commencement of audit in the taxpayer's place.

We observed in 10 Commissionerates[43] that out of 609 files test checked, there was delay in submission of draft audit reports in 344 files during the period 2012-13 to 2014-15. Out of these 344 files, three DARs were submitted with delay of more than one year and in 55 DARs delay was ranging from three months to one year. Moreover, in 81 cases we could not quantify the delay in submission of draft audit reports due to absence of information.

A few cases are illustrated below:

- In Delhi ST Audit I Commissionerate, in case of M/s Richo India Ltd., the DAR was submitted with the delay of 776 days.

- In Chandigarh Audit Commissionerate, in case of M/s Ludhiana Builders, the DAR was submitted with the delay of 685 days.

- In Bangalore ST Audit Commissionerate, in case of M/s Vodafone South Ltd., the DAR was submitted with the delay of 530 days.

When we pointed this out (October 2015 to April 2016), the Ministry accepted (December 2016) the audit objection and attributed the delay in submission of draft audit report to delay in receipt of documents/replies or non-cooperation by the assessees.

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[42]   Bhopal Audit I, Bhopal Audit II, Hyderabad Audit, Chennai Audit I, Chandigarh Audit and Patna Audit

[43]   Bangalore ST Audit, Chennai Audit I, Chandigarh Audit, Delhi ST Audit I, Kolkata ST Audit, Hyderabad Audit, Bhubaneswar Audit, Lucknow Audit , Patna Audit and Cochin Audit

3.9.4   Evaluation of Audit Reports

As per para 8.3.2 of Chapter 8 of the STAM, 2011, the Monitoring Committee should also evaluate the working of Audit Groups in respect of each audit. The scoring of Audit Report should be done with a view to evaluate the standard of audit conducted. Greater emphasis should be placed on the quality of audit and recovery of short levy rather than on the quantum of detection.   The evaluation is not meant for reprimanding or fixing responsibility but is aimed at assessing the quality of audit and correcting the shortcomings for future.

We observed in eight Commissionerates[44], that out of a total 560 internal audit files, no scoring had been done in 388 files (69 *per cent*). Moreover, in 177 files (32 per cent) in three Commissionerates[45], no scoring was done in any of the internal audit files.

When we pointed this out (October 2015 to April 2016), the Ministry accepted the facts and stated (December 2016) that the audit comment is noted for future compliance.

3.9.5   Monitoring Committee Meeting (MCM)

As per para 8.2.2 of the STAM, 2011, the Audit cell should organize Monitoring Committee Meetings (MCM) on at least monthly basis under the chairmanship of the Commissioner during which each of the audit objection/observations would be examined for its sustainability. The minutes of each such meeting should be drawn, pointing out the decision on each of the audit objection regarding its sustainability and directions for future action. The objections rejected by the meeting will be treated as closed.

We observed that during the period 2012-13 to 2014-15, in six Audit Commissionerates (including related executive Commissionerates)[46] 209 monthly MCMs were held as against 306 MCMs due to be conducted. Hence, there was a shortfall of 97 MCMs (31.70 *per cent*).

When we pointed this out (October 2015 to April 2016), the Ministry accepted the facts and stated (December 2016) that it was due to restructuring of the department and that the MCMs are being held regularly now.

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[44]   Bangalore ST Audit, Lucknow Audit, Patna Audit, Ahmedabad Audit II, Delhi ST Audit I, Chennai Audit I, Cochin Audit and Mumbai ST Audit III.

[45]   Delhi ST Audit I (25 cases),Mumbai ST Audit III (77 cases) and Ahmedabad Audit II (75 cases)

[46]   Patna Audit (including Ranchi Executive Commissionerate), Chennai Audit I (including Chennai III Executive Commissionerate), Cochin Audit (Calicut and Thiruvananthapuram Executive Commissionerate), Lucknow Audit, Kolkata ST Audit and Mumbai ST Audit III

3.9.6   *Finalization and Issuance of Final Audit Report*

As per para 8.3.1 of the STAM, 2011, based on the decision of the MCM, the draft audit report should be finalized by the Audit Cell within 15 days from the date of MCM.

We observed in 13 Audit Commissionerates that out of 813 test check files, there was delay in finalization of draft audit report in 291 cases. The delay was up to three months in 213 cases and more than three months in 78 cases.

A few cases are illustrated below:

•   In Bangalore ST Audit Commissionerate, in the case of M/s Starworth Infra & Construction Ltd., the delay was of 518 days after the discussion in MCM. In case of M/s Parametric Technology Pvt. Ltd. and M/s Divas Langdon & Sech Consulting Pvt. Ltd., the delay was of more than 300 days after the discussion in MCM.

•   In Delhi ST Audit I Commissionerate, out of the selected sample, none of the FARs found to be issued in time. Two FARs were issued with delay of more than one year after the discussion in the MCM and in eight cases FARs were yet to be issued (April 2016) though the same were discussed in MCM held in February to April 2015.

•   In Cochin Audit I Commissionerate, in case of M/s Invis Multimedia Ltd., the delay was of 247 days in issuing the Final Audit Report after the discussion in MCM.

When we pointed this out (October 2015 to April 2016), the Ministry accepted the audit objection and stated (December 2016) that the delay in finalization of draft audit reports was for want of recovery particulars in respect of the observations accepted by the assessees or compliance of queries raised in MCM committees.

Improper maintenance of Audit Planning and Follow up Registers have direct impact on effective watch on internal audit process. Further, non-maintenance of timeliness in issuance of FAR to the assessee doesn't reflect well on the image of the department.

3.10   Conclusion

Risk based audit has been adversely affected due to non/ incomplete maintenance of Assessee Master Files in most of the cases. The Ministry needs to devise proper risk assessment at Commissionerate level keeping in view centralised risk scoring of assessees being done by DG Audit currently. Lacunae such as poor desk review, audit planning and non-documentation of

verification reports raise questions on the quality of work done by IAP. Further, Draft Audit Reports are being finalised with significant delay and adherence to the timelines is not monitored. Poor maintenance of records by a wing which is the backbone of the compliance verification mechanism reflects poorly on the functioning of the department.